SEPTEMBER 16, 2022

The Market Letter

Interest rates are to asset prices like gravity is to the apple. They power everything in the economic universe."

— Warren Buffett in 2013

Market Commentary

The stock market has staged a comeback from the June lows but is still down considerably so far this year. In Canada, the TSX is down nearly 11% since the March 29th high, while in the U.S., the S&P500 is down nearly 18% from the high on January 3rd. In my last letter, I discussed how the stock market was focused on the war in Ukraine, inflation, and China's failed "zero-covid" strategy. While all 3 factors continue to make 2022 a challenging year for stocks, inflation has by far become the dominant headwind.

It's all about inflation & interest rates and Warren Buffett would agree. Inflation is an enormous problem and it's a problem in all major global economies. Reckless government spending in Canada and the U.S. and money printing by central banks have finally caught up. During the Covid crisis, Canada increased its money supply by 40%. Central bankers can lie and call it quantitative easing, but it's simply printing new money, full stop, no argument. Yes, the war in Ukraine has contributed to price pressures, particularly in Europe where energy prices have sky-rocketed due to an overdependence on Russian natural gas. In North America this is a non-issue and oil prices are now back to where they were at the start of the invasion. The groundwork for high inflation was laid before Russia invaded and the blame lies squarely with our political leaders and central bankers.

Where do we go from here? Central banks have scrambled to raise interest rates to try and cool the economy and tame inflation. This year we have seen the most aggressive interest rate increases in decades. The Bank of Canada has termed this "front loading". In reality, they kept rates too low for too long and are simply playing catch up. The risk here is that they raise rates too fast and cause a severe recession. After raising interest rates by 0.75% this month, our Chief Economist is forecasting another 0.50% increase in October, which would bring us to 3.75%. If the economy starts to cool into next year, they will likely have to pause on further rate increases after that.

Why are inflation and higher interest rates a problem for the stock market? Higher interest rates are necessary to cool an overheated economy. They also make stocks less attractive relative to cash and fixed income investments such as bonds and GICs. Although the stock market is still the place to be for long term investors, conservative investors who have less tolerance for risk and volatility can now get a reasonable return on cash and government guaranteed investments. With GIC rates around 5% and money market funds paying 3%, there are alternatives to being fully invested in the stock market.

What will happen with the stock market? With a mild recession next year looking increasingly likely, we could start to see a stabilization and more sustained recovery in the stock market if interest rates peak and start to come down. Although it's important to remain diversified, we have a bias towards the Canadian stock market. Canada is better off if oil & gas prices remain high because energy accounts for 30% of our exports. Our agricultural sector has enjoyed a bumper crop this year unlike many other parts of the World, which have suffered a record drought. Our housing market is also not as vulnerable as many think due to high immigration and strong demographics. Although mortgage rates are moving higher, two-thirds of variable mortgages have fixed payments. The interest component of a payment increases but the overall payment remains the same. Hopefully this limits the pain to the Canadian consumer.

Basket Update

For exposure to good-quality Canadian companies, our Growth & Income Private Portfolio (Basket) continues to perform well despite a challenging stock market. **Our 1-year return to August 31st was +2.4% and our return since inception has been +10.7% per year.** We have outperformed the TSX Total Return Index as we have avoided the more volatile and speculative areas of the market. We stick with high quality companies with solid balance sheets paying sustainable and growing dividends. Portfolio turnover is low, and we plan on owning most of our companies for many years.

We have made some changes since our last update in April. We initiated a position in Kinaxis (KXS), a leading supply chain management software company. With rising geopolitical risks and trade bottlenecks, companies are investing heavily to optimize their supply chains. We also took some profits and sold our entire position in Toromont Industries (TIH) and switched into WSP Global (WSP). WSP is one of the world's largest engineering and consulting firms. With governments investing heavily in infrastructure, particularly to mitigate the effects of climate change, WSP is an industry leader and is well positioned. Lastly, we sold our entire position in TD Bank (TD) and switched into CIBC (CM). TD has higher exposure to volatile markets in the U.S. while CIBC has a more conservative business mix. CIBC also pays a higher dividend (5.2% vs. 4%) and we believe the defensive nature of their business is more appropriate in this economic environment.

Fixed Income Rates

Daily Money	
NBI Cash Performer (CAD)	3.00%
NBI Cash Performer (USD)	2.35%

GICs		Mortgage Rates	
1-Year	4.32%	1-Year fixed	5.04%
2-Year	4.47%	2-Year fixed	5.14%
3-Year	4.55%	3-Year fixed	5.19%
4-Year	4.56%	4-Year fixed	5.24%
5-Year	4.62%	5-Year fixed	5.24%
		Variable rate	Prime – 0.45% = 5.00%

Rates are as of September 15, 2022 and are subject to change at any time.

Client Communications

I periodically email economic & geopolitical updates. For those that would like to receive these updates and are not already, please let us know. Please also let us know if your email address has changed.

Referrals

My clients often ask me if it's okay to refer family and friends. I want to emphasize that this is highly encouraged! My practice is built on word of mouth and I am always happy to sit down with a prospective client to discuss my process. If you feel it is appropriate, please feel free to share my contact information.

I have prepared this commentary to give you my thoughts on various investment alternatives and considerations which may be relevant to your portfolio. **This commentary reflects my opinions alone and may not reflect the views of National Bank Financial Group.** In expressing these opinions, I bring my best judgment and professional experience from the perspective of someone who surveys a broad range of investments. Therefore, this report should be viewed as a reflection of my informed opinions rather than analyses produced by the Research Department of National Bank Financial.

The securities or sectors mentioned in this letter are not suitable for all types of investors and should not be considered as recommendations. Please consult your investment advisor to verify whether this security or sector is suitable for you and to obtain complete information, including the main risk factors.

– Ian Stockdill

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